

1 DAUFUSKIE ISLAND UTILITY COMPANY, INC.

2 DOCKET NO. 2011-229-W/S

3 Rebuttal Testimony of John F. Guastella

4 Before the South Carolina Public Service Commission

5 Testimony Prepared: May 15, 2012

6 Hearing Date: May 30, 2012

7

8 **Q. Please state your name and business address.**

9 A. John F. Guastella, Guastella Associates, LLC, 6 Beacon Street, Suite 200, Boston,
10 MA 02108.

11

12 **Q. By whom are you employed?**

13 A. I am president of Guastella Associates, LLC.

14

15 **Q. Have you previously submitted direct testimony and exhibits in this**
16 **proceeding in support of DIUC's rate application?**

17 A. Yes.

18

19 **Q. Have you examined the testimonies and exhibits of Ms. Christine Stutz, Mr.**
20 **Willie J. Morgan and Dr. Douglas H. Carlisle that were filed on behalf of the**
21 **Office of Regulatory Staff ("ORS")?**

22 A. Yes.

23

1 **Q. Do you have any general comments with respect to your rebuttal testimony**
2 **regarding the ORS witnesses?**

3 A. Yes. While I do not have a concern or objection as to some of the rate setting
4 adjustments and reconciliations of the ORS witnesses, the basis for some of the
5 adjustments and recommendations, departs from the required goal of establishing
6 rates that truly reflect the cost of providing safe and adequate service. In
7 establishing rates for DIUC, it is important to recognize that DIUC is a very small
8 water and sewer utility with a relatively small number of customers over which to
9 spread costs. DIUC's location on an island adds to a greater level of costs to both
10 its operations and capital requirements. The former Haig Point Utility Company
11 ("HPUC") and Melrose Utility Company ("MUC") were created in connection
12 with real estate developments. On the basis of my previous consulting work on
13 behalf of HPUC, I know that its stockholder, International Paper ("IP") did not
14 have management personnel with specific utility regulatory experience, and the
15 utility operation was not a significant focal point in relation to its other business
16 activities. The transition from IP to CK Materials ownership has required
17 extensive work in order to establishing proper financial and billing records.

18 With respect to MUC, within a couple of months after we began managing
19 DIUC, I found that MUC had not been paying its 40% share of the joint venture
20 Haig Point/Melrose Wastewater Treatment Plant. As I discussed in my direct
21 testimony, this loss of about 25-30% of our annual revenues created a serious cash
22 flow problem. After MUC's bankruptcy and merger into DIUC, there were no

1 books and records made available, but fortunately the billing company MUC had
2 been using was the same as DIUC's.

3 My next general comment is to make clear and unequivocal that the
4 highest priority goal of the stockholder (CK Materials) and I is to make absolutely
5 sure that DIUC is financially capable of providing safe and adequate service to
6 our customers. The surest way to do that is to establish the actual cost of
7 providing service -- consistent with the Supreme Court guidepost decision in
8 Federal Power Commission v. the Hope Natural Gas, Co., U.S. 591 (1944),
9 requiring enough revenue to cover the operating and capital costs of the utility.

10 My last general comment is that we are very much aware of the
11 customers' expressed concerns about the magnitude of the proposed rate increase.
12 We also appreciate the ORS's and PSC's responsibility to make sure that the rates
13 are reasonable and necessary for DIUC to provide adequate service. The PSC's
14 current rate setting policy that does not permit projected test years or allow capital
15 improvements that are not in service presents an almost insurmountable problem
16 for a small water and wastewater utility. As is typical, lending institutions will
17 not provide debt financing to a small utility unless it can demonstrate adequate
18 earnings that will cover the new debt service. This reality is the specific situation
19 we have experienced in trying to obtain either short or long term debt for DIUC.
20 The rate increase must reflect adequate debt service coverage if the Utility is to
21 continue to provide adequate service.

22

1 **Q. Why do you preference your rebuttal testimony with these general**
2 **comments?**

3 A. I believe it is important for the PSC to understand how the change in ownership
4 and management of the former HPUC and MUC dealt with small utilities with
5 significant problems, absorbed a major loss of revenues and yet provided good
6 service to the customers, all with a degree of financial sacrifice of the
7 Stockholders, operators, management and vendors. Hanging in the balance of this
8 rate decision is the impending debt financing and health of the company as a
9 viable utility.

10

11 **Q. Do you agree with the adjustments made by the ORS?**

12 A. As time permits, we will request ORS to provide more detail as to many of its
13 adjustments to both the original cost of utility plant in service and operating
14 expenses. We disagree with adjustments made by Ms. Stutz that a booked cost
15 should be eliminated merely because it is “undocumented” or an invoice for it
16 cannot be found. For example, the cost of utility plant added subsequent to
17 HPUC and MUC last rate cases and before acquisition by CK Materials in July,
18 2008 and March, 2010, respectively, was booked and/or recorded in reports to the
19 PSC. There is no question that facilities exist and are used and useful, and clearly
20 there was a cost incurred for their installation. The absence of invoices does not
21 establish that there was no cost, or no cost should be allowed for rate setting. It
22 has been my experience that the predominant rate setting treatment, if there is no

1 invoice or records, is to determine whether the booked cost is reasonable -- by
2 performing original cost estimates.

3

4 **Q. Do you agree with the adjustment to eliminate the cost of the elevated storage**
5 **tank in the amount of \$863,379 because of the land at the site was sold at a**
6 **tax sale?**

7 A. No. We were not aware of the tax sale because Beaufort County sent bills to the
8 wrong addresses, though it had been informed of our correct address after the
9 acquisition by CK Materials. Beaufort County also did not post notices of the
10 pending sale of the site, as required. We have taken steps to reverse the sale. In
11 any event, there is absolutely no possibility that the Storage Tank will not
12 continue to be used to provide water service -- this is known as a certainty and the
13 cost of the tank is known and measurable. Disallowing the cost of this tank is
14 unreasonable.

15

16 **Q. Do you agree with the elimination of the cost of land?**

17 A. No. The failure of previous owners to maintain the records as to the cost of land
18 does not preclude a recognition of an estimated cost. The land exists and it is
19 used and useful, and it is subject to property tax.

20

21 **Q. Would you comment about the adjustments Ms. Stutz has proposed to the**
22 **operating expenses?**

1 A. Yes. Without addressing each adjustment separately, I disagree with those
2 adjustments that were made due to lack of documentation if the expenses were
3 obviously incurred in serving the customers. I also disagree with adjustments that
4 were made because they are not known and measurable where the reason for that
5 position is the expense has not yet been paid. For example, we have submitted an
6 application for insurance with Grundy Agency and reflect the estimated cost in
7 DIUC's revenue requirement. Ms. Stutz disallowed the expense because the
8 amount has not been paid yet. "Known and measurable" should not be restricted
9 to only costs that have been paid. There is no question that we will obtain
10 insurance and the cost is measured on the basis of an estimate.

11 Another example is Ms. Stutz disallowance of the cost and expense related
12 to a new billing system. There is a need to switch to a billing system that will be
13 an improvement over the existing system that was carried over from previous
14 ownership. Because of limited cash flow, we have had to wait to make some
15 improvements, but it is certainly a reasonable rate setting approach to allow a
16 known and measureable cost (we have a specific proposal for the new billing
17 system).

18 With respect to outside services for engineering, Ms. Stutz rejects DIUC's
19 use of five-year average because it is not typically made for normal test year
20 expense items and allows the test year expense. I disagree, in my experience, the
21 typical way to normalize expenses that fluctuate significantly from year to year is
22 to use an average. We also obtained invoices from the engineering firm for the

1 \$5,584 that Ms. Stutz eliminated as being undocumented, for work related to the
2 preparation of consumer confidence reports.

3

4 **Q. Do you agree with the Dr. Carlisle's recommendation with respect to the rate**
5 **return on equity?**

6 A. While the DCF and CEM analyses by Dr. Carlisle may be appropriate for the
7 large water utilities, they simply do not take into account the realities of a small
8 water and wastewater utility. For example, Ms. Stutz proposes adjustments for
9 wages, insurance, engineering costs, a new billing system, and a variety of others.
10 While those disallowances are proposed for rate setting (with which we disagree),
11 the reality is that DIUC will be incurring these expenses. Accordingly, the actual
12 earnings DIUC would achieve in the year the new rates become effective, if they
13 reflect acceptance of ORS's adjustments, would fall significantly short of Dr.
14 Carlisle's recommended level. Moreover, ORS has proposed rate base
15 adjustments for the cost of various facilities that exist and are used and useful in
16 providing service. Furthermore, not a penny of the capital improvements that
17 both DIUC and ORS anticipates with construction beginning in the first year the
18 new rates become effective, is included in the rate base to which Dr. Carlisle's
19 rate of return is applied. Accordingly, rates reflecting all of ORS's
20 recommendations would produce significantly less actual earnings on an actual
21 net investment that is significantly higher. The result would be an actual equity
22 rate of return considerably less than Dr. Carlisle's recommendation --

1 demonstrating the reality that small utility characteristics are not taken into
2 account in the DCF and CEM analyses.

3

4 **Q. Do you agree with the recommendation of both Dr. Carlisle and Mr. Morgan**
5 **with respect to request permission from the PSC before DIUC pays**
6 **dividends to its stockholders?**

7 A. No. There is no basis for such a recommendation and it could be counter-
8 productive. Since acquiring HPUC and MUC, CK Materials and DIUC have
9 provided adequate service to the customers, despite such unanticipated adverse
10 circumstances as a loss of 25-30% of annual revenues attributable to MUC's
11 former owner, and a lack of records and proper management. The proposed rate
12 increase includes the conversion of a portion of equity into debt (for the primary
13 reason of providing DIUC with funding necessary for capital improvements) as a
14 way of overcoming the dilemma in which projected capital improvements are
15 excluded from rate base and potential investors unwillingness to lend money until
16 they are included in rate base. The imputation of debt is a known and measurable
17 change that reduces the revenue requirement. It has a lower cost rate than equity
18 and its interest is a reduction of income tax expense. If ORS is concerned about
19 the need to make capital improvements and wants additional assurance beyond
20 the stated purpose of the debt financing in DIUC's rate filing, DIUC would agree
21 to a stated commitment in the PSC's order to use proceeds of the debt financing
22 for capital improvements, assuming of course that the rate increase is enough to

1 enable the issuance of debt and cover accounts payable and working capital
2 needs.

3 The ORS recommendation that permission would be needed before paying
4 dividends conveys a negative connotation that may impact the ability to obtain a
5 loan, which would be counter-productive and not in the best interests of the
6 customers.

7 It is noted that dividends are paid out of retained earnings. In the
8 conversion of equity into debt, the proceeds of the debt financing will be recorded
9 as a credit to long-term debt and debit to cash. The payment to CK Materials in
10 order for it to pay off its loan with Coastal States Bank would be a credit to cash
11 and debit to paid-in-capital. The use of cash is essentially the use of equity to
12 cover DIUC operating costs. Any payments to CK Materials, assuming money is
13 available after paying capital improvements, would be a debit to paid-in-capital,
14 not a dividend payment.

15

16 **Q. Have you reviewed the issue of availability fees related to Oak Ridge and**
17 **Beach Field lots?**

18 A. When acquiring MUC, its billing records did not contain information about those
19 areas. We have compiled a list of owners of the lots in those areas and have
20 provided it to ORS. It appears that as many as some 100, plus or minus, may be
21 subject to availability charges. We will continue to determine the exact number
22 and, once known, we believe it would be appropriate to reflect additional

1 availability revenues -- as known and measurable even though the revenues have
2 not actually been received.

3

4 **Q. Do you have any comments regarding the testimonies of Mr. Lynn M. Lanier**
5 **and Ms. Ellen Blumenthal?**

6 A. Yes. Some of their proposed adjustments are similar to those of the ORS, which I
7 have previously addressed. With respect to rate case expenses, the amount
8 included in this rate filing are less than the amount allowed in the recent rate case
9 of Kiawah Island Utility, Inc. Docket No. 2011-317-W/S, even though the process
10 required the same effort. The lower rate case expense is, for the most part, due to
11 the self-imposed limit of my firm's charges.

12 With respect to management fees, these witnesses provide no analysis
13 supporting their proposed reductions. They don't mention that adequate service
14 has been provided despite the loss of 25-30% of revenues, beyond control of
15 DIUC. They don't mention that DIUC essentially operated MUC without
16 compensation after the MUC's system was abandoned and without which service
17 would have been disrupted for an unknown period of time. Although referencing
18 the Kiawah Island Utility case for rate of return comparisons, they don't mention
19 that DIUC's proposed rates are about the same as those granted for Kiawah. They
20 don't discuss the reality that DIUC has less than 20% of the number of customers,
21 and the rates should be higher on a per customer basis. They don't mention that
22 the cost of operations on an island with no direct access except by boat is more
23 costly. And, they don't mention that the HPCCA entered into a settlement

1 agreement in the acquisition of HPUC by CK Materials requiring DIUC to retain
2 Guastella as the manager as a condition to approve the acquisition.

3 With respect to rate of return, Mr. Lanier recommends an overall rate of
4 return of 4.3%, with an equity rate of 2.86% that is less than 50% of the debt rate
5 of 5.75%. I have been involved in thousands of rate cases and have never seen a
6 recommendation in which the cost of equity is less than the cost of debt -- beyond
7 understanding.

8 In sum, if Ms. Blumenthal's and Mr. Lanier's recommendations are
9 accepted, there would be no ability to attract capital for needed capital
10 improvements, and no ability to assure continued adequate service.

11 Finally, DIUC and MUC systems are functionally integrated as to billing,
12 accounting, operations, management, financing and administrative costs. Single
13 tariff pricing under which all customers pay the same rates for the same service is
14 the preferable rate structure.

15

16 **Q. Does this conclude your testimony at this time?**

17 **A. Yes.**